Supreme Court, U.S.
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No. 01-1418

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,

Petitioners,

v.

ARLENE L. WARNER,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

BRIEF FOR RESPONDENT ARLENE L. WARNER

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QUESTIONS PRESENTED

1. Whether creditors are precluded from asserting that a debt represented by a promissory note arises from fraud and is nondischargeable under 11 U.S.C. § 523(a)(2)(A), when the note was given in settlement of a prior state-court litigation, and that settlement was incorporated into a final judgment on the merits that is, under state law, collateral estoppel against the creditors on the precise fraud issue to be asserted under Section 523(a)(2)(A).

2. Whether 11 U.S.C. § 523(a)(2)(A) permits creditors to assert that a promissory note debt is nondischargeable because it arises from fraud, when the note was received as consideration in a contractual settlement of disputed litigation in which the creditors expressly released, and agreed never to reassert, the very allegations of fraud on which the nondischargeability claim rests.

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BRIEF FOR RESPONDENT

STATEMENT

This case poses the question whether Section 523(a)(2)(A) of the Bankruptcy Code, which excepts debts based on fraud from discharge in bankruptcy, overrides the usual power of litigants — including creditors — to release and forswear the later assertion of disputed claims, including claims of fraud, in order to reach a settlement acceptable to both sides. Petitioners contend that various policy concerns in bankruptcy require a departure from the usual rule that a party is free to relinquish his own claims. As a result, they argue that no pre-bankruptcy settlement — however explicit it may be in disposing of the issue of fraud — may ever foreclose assertion of fraud in order to establish that the settlement debt is excepted from discharge under Section 523(a)(2)(A).

On the facts of this case, this contention flies directly in the teeth of this Court's clear precedent. The parties' state-court settlement and categorical release of the fraud claim was incorporated into a judgment on the merits by way of a voluntary dismissal with prejudice. Under governing North Carolina law, the judgment thus entered is binding as collateral estoppel against any future fraud allegations encompassed within those issues resolved by the North Carolina court. Because this Court has held explicitly that collateral-estoppel principles bind bankruptcy courts, specifically in determinations of issues under Section 523(a), the bankruptcy court must give the same preclusive effect to the state-court judgment that the rendering North Carolina court itself would give.

While collateral estoppel plainly compels the outcome here, this case should be resolved under a broader rule. Given that bankruptcy courts must follow state law of collateral estoppel insofar as it renders a state-court settlement judgment binding on the issue of fraud, no compelling reason appears why bankruptcy courts should not also be bound by contractual

settlements that are enforceable under state law. Plainly, the viability of the settlement process depends on the capacity of litigants to enter into binding contracts. Where, as here, a settlement contract is enforceable under state law and has the effect of preventing one party from resurrecting a particular allegation (because it has been expressly released for all time), that contract should be given effect in bankruptcy, barring some provision of the Code directing a contrary conclusion. No such contravening Code provision exists here, even though Congress has expressly provided, with regard to two other narrow categories of claims, that settlement contracts will not be enforced as to render a debt dischargeable. And just as there is no contravening statutory language, none of the bankruptcy policy arguments offered by petitioners supports denying the parties' settlement its obvious contractual effect of foreclosing any further allegation of fraud.

* * *

In the spring of 1992, petitioners Elliott and Carol Archer negotiated with respondent's husband, Leonard Warner, to purchase the assets of Warner Manufacturing, Inc. J.A. 36-41. On May 22, 1992, Leonard Warner and his son, Stuart Warner, entered into an agreement on behalf of Warner Manufacturing to sell the company's assets for $685,000 to a corporation formed by petitioners. Pet. App. 2a; J.A. 41.

In late 1992, petitioners filed a complaint in the Superior Court of Guilford County, North Carolina, alleging misconduct in connection with the sale and naming as defendants only Leonard Warner and Warner Manufacturing. Pet. App. 2a; J.A. 100. Around the same time, and based upon the same alleged conduct, the State of North Carolina indicted Leonard Warner on a charge of obtaining property by false pretenses. J.A. 32-33. Over a year later, on March 2, 1994, petitioners amended their complaint to add respondent Arlene Warner as a defendant. But petitioners confined their allegations concerning respondent to conclusory statements contained in a single paragraph of the complaint and did not

assert any specific acts by her in connection with the sale transaction. J.A. 46, ¶ 39.

The amended complaint contained counts alleging breach of contract, fraud and misrepresentation, conspiracy, piercing the corporate veil, fraudulent conveyance, statutory unfair or deceptive trade practices, and constructive trust. J.A. 47-58. The parties to the state-court action conducted extensive pre-trial discovery and negotiations. On May 11, 1995, the parties, all represented by counsel, settled the litigation. J.A. 61. They executed a "Settlement Agreement," J.A. 61-66, and two separate releases, which they characterized as a "General Release" and a "Mutual Release." J.A. 67-72.

The Settlement Agreement stated that petitioners' willingness to settle was motivated by, among other things, the "numerous defenses asserted by the defendants." J.A. 62. It provided further that payment was intended "as compensation for emotional distress/personal injury type damages," J.A. 61, petitioners having amended their complaint three days before settlement to include claims for intentional and negligent infliction of emotional distress. Pet. App. 2a. "Leonard L. Warner or one or more of the other defendants" had to give petitioners a $200,000 certified check and a $100,000 promissory note secured by a second lien on specific property owned by Leonard and Arlene Warner. J.A. 61-62, 73-76. The entire settlement was expressly conditioned upon dismissal of the pending criminal action against Leonard Warner. J.A. 63, 77.

In consideration of the Warners' commitment, and the immediate delivery of a payment of $200,000 and a conforming note and deeds of trust, petitioners executed a "General Release," stating that they:

> hereby release and forever discharge [the Warners] from any and every right, claim, or demand which [petitioners] now have or might otherwise hereafter have against the [the Warners] from the beginning of the world to the date of this release arising out of or relating to the matter of the

> litigation in Guilford County Superior Court . . . excepting only obligations under a Note and deeds of trust executed contemporaneously herewith.

J.A. 67. The General Release acknowledged that the state-court defendants "expressly denied" any liability. J.A. 68.

The parties to the state-court action also executed a Mutual Release, "cumulative" with the General Release, in which they recited that the settlement was "the compromise of disputed claims" carrying no admission of liability, "all such liability being expressly denied." J.A. 70, 71. As the name suggests, in the Mutual Release the parties released each other

> from any and every right, claim, or demand . . . from the beginning of the world to the date of this release, particularly including, but not limited to, all claims, demands and causes of action in the Lawsuit and all claims, demands and causes of action that could have been asserted therein, excepting only obligations under a Promissory Note and Mortgages executed simultaneously or near simultaneously herewith.

J.A. 70-71. The Mutual Release further provided that "[t]he terms of the two releases [General and Mutual] are contractual in nature and not mere recitals" and that each party signed the "release . . . willingly and voluntarily and with full knowledge of all facts and other matters relevant to the Lawsuit." J.A. 71.

The Settlement Agreement expressly provided that the parties would not "avoid or attempt to avoid the legal obligation to consummate the settlement of this litigation on the above terms and [would execute a] dismissal with prejudice of the litigation." J.A. 63. The Mutual Release similarly provided that the "Lawsuit and all claims therein will be dismissed with prejudice by the plaintiffs forthwith." J.A. 71.

On May 15, 1995, petitioners filed their notice of voluntary dismissal of the state-court litigation "with prejudice." J.A.

80-81. Under North Carolina law, this dismissal operated as a final judgment on the merits that resolved all claims in the complaint against the petitioners. *See Miller Bldg. Corp. v. NBBJ North Carolina, Inc.*, 497 S.E.2d 433, 435 (N.C. Ct. App. 1998); *Bailey v. Gitt*, 518 S.E.2d 794, 795 (N.C. Ct. App. 1999). *See* pp. 15-20 *infra*.

The Warners defaulted on a note payment due November 11, 1995. On December 4, 1995, petitioners sued in state court for "collection on the note," making no allegations of fraud or other claims raised in the original litigation. Pet. App. 3a. While that suit was pending, on February 5, 1996, the Warners filed a petition for relief under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the Middle District of North Carolina, which was later converted to a Chapter 7 proceeding. *Id.*

In March 1996, petitioners filed a proof of claim in the bankruptcy court for $122,480.13, an amount comprising the principal, interest, and attorneys' fees alleged to be owing under the terms of the note. J.A. 82-84. Ten months later, petitioners filed an adversary proceeding in the bankruptcy court alleging that this claim was nondischargeable under Section 523(a)(2)(A) of the Bankruptcy Code, which they supported only by incorporating the allegations of the amended state-court complaint. J.A. 88; Pet. App. 4a.

In response to that nondischargeability claim, on May 27, 1997, Leonard Weaver signed a "consent order" that reaffirmed the debt and authorized entry of a bankruptcy-court order "declaring that defendant Leonard L. Warner's debt to plaintiffs is nondischargeable." Pet. App. 39a, 41a. Respondent, however, answered the nondischargeability claim and asserted that the "$100,000.00 debt to the [petitioners] arising [from] the settlement of Guilford County Civil Action 92 CVS 777 . . . did not arise from any fraud, . . . so as to be a non-dischargeable debt under 11 U.S.C. Section 523(a)(2)." J.A. 93-94.

On June 25, 1998, petitioners moved to amend their Section 523(a) complaint to set forth, for the first time, specific actions allegedly taken by respondent, *see* J.A. 97-100, and to contend, also for the first time, that the Warners had "fraudulently induced" petitioners to accept the note as part of a settlement "with no present intention to pay the same." J.A. 104-05. The bankruptcy court denied the motion to amend because petitioners' attorney did not appear on the date the motion was to be heard. Pet. App. 4a-5a n.4; J.A. 109. On May 27, 1999, nearly eleven months later, petitioners renewed their motion to amend, but the bankruptcy court again denied the motion for reasons that do not appear on the record. Pet. App. 4a-5a n.4; J.A. 111, 127. Petitioners do not challenge these rulings in this Court. Pet. Br. 8 n.5.

On August 26, 1999, the bankruptcy court held a hearing and ruled that the debt on the note was dischargeable. Pet. App. 29a. The court held that the allegations of fraud "were included in the settlement" entered into by the parties, Pet. App. 32a, and that there is "nothing in § 523(a) which can be read as making it unlawful or illegal for a [creditor] alleging fraud to enter into a settlement under which [the creditor] agrees to release any claim which might arise in the future under § 523." Pet. App. 34a. Here, the court reasoned, petitioners executed a "broad" release "after [they] and their counsel had the benefit of extensive information developed through prolonged discovery." Pet. App. 35a. In view of that fact, and the facts that petitioners had "received the cash payment of $200,000.00 as well as the promissory note and deeds of trust, [petitioners] may not now raise the dischargeability claim they now assert based upon the same allegations and claims contained in the complaint in their original action." *Id.* "[T]he only misconduct alleged in this action is the same misconduct described in the original complaint which plaintiffs dismissed with prejudice pursuant to the settlement." *Id.*

The district court affirmed, stating that the "bankruptcy court correctly concluded that the settlement agreement and general release created a novation, substituting a contract debt for a debt arising from tort, and that the debt was therefore dischargeable in bankruptcy." Pet. App. 21a. The "settlement agreement contained a complete release," and "[t]here is absolutely nothing about federal bankruptcy law that should disturb that state law outcome." Pet. App. 22a, 23a. "[N]othing in the Bankruptcy Code interrupts the ordinary capacity of creditors under nonbankruptcy law to contract for the release of claims that are or might be nondischargeable in bankruptcy." Pet. App. 24a (quotation omitted).

The district court noted specifically that "there are several reliable ways to ensure that a debt for fraud does not become dischargeable in bankruptcy after the parties settle the claim." The creditor can make "the debtor admit to specific allegations of fraud as findings of fact in the settlement agreement, . . . make the debtor acknowledge that any release of liability is conditional until full payment is made," and/or require that the settlement agreement "be subject to plaintiff's right to assert non-dischargeability in a bankruptcy proceeding." Pet. App. 24a.

The Fourth Circuit affirmed the district court, agreeing with decisions of two other circuits holding that "parties willing to settle disputes over fraud, misrepresentation, or like tort claims may do so by way of settlement through contract, and such contractual claims are then dischargeable in bankruptcy." Pet. App. 8a. The court found no evidence of congressional intent "to discourage the settlement of claims because they might be subject to freedom from discharge under § 523(a)." *Id.* Here, the "settlement package . . . announced the complete waiver of all pending and future related personal claims against Arlene Warner." Pet. App. 9a. Because the "settlement agreement and promissory note here, coupled with the broad language of the release, completely addressed and released each and every underlying state law claim" including

fraud, the Fourth Circuit held that petitioners had relinquished their right to assert fraud as a basis for nondischargeability under Section 523(a). Pet. App. 10a.

Judge Traxler dissented, endorsing a line of circuit cases that he said best effectuated Congress's policy favoring "the fullest possible inquiry into the nature of the debt and limiting relief to the honest but unfortunate debtor." Pet. App. 14a. Judge Traxler stated that a debtor could "completely immunize himself from § 523 by simply settling any fraud claims against him with a promise to pay, having the plaintiff release the underlying tort action as part of the settlement, and then filing for bankruptcy." *Id.*

SUMMARY OF ARGUMENT

This Court's clear precedents and ordinary principles of collateral estoppel compel affirmance of the decision below. This Court has held that collateral estoppel applies in Section 523(a) discharge proceedings, and, under the Full Faith and Credit Statute, federal courts — including bankruptcy courts — must give the same preclusive effect to state-court judgments that those state courts would give them. Here, petitioners and respondent executed a settlement agreement and categorical release of petitioners' fraud (and other) allegations. Petitioners then filed a voluntary dismissal of their state action with prejudice, which, under North Carolina law of collateral estoppel, operated as a judgment on the merits that resolved all contentions in the complaint against the petitioners. Petitioners' theory of fraud in the state-court litigation is identical to the theory of fraud pleaded in their Section 523(a) complaint. Furthermore, the elements of fraud under North Carolina law and under Section 523(a) are identical, as are the burdens of proof imposed upon the complainant. Thus, under this Court's clear precedent and the governing collateral-estoppel law of North Carolina, petitioners' allegations of fraud have been determined on the merits, and petitioners are foreclosed from asserting fraud as a ground for nondischargeability under Section 523(a).

Although this case can be resolved by the straightforward application of collateral-estoppel principles, it should be resolved on broader grounds. Where parties form a valid, enforceable contract in which they stipulate to facts or relinquish certain claims in order to achieve settlement, bankruptcy courts should limit the parties to asserting whatever rights remain to them under that settlement contract. A creditor's property rights against the bankruptcy estate are defined by state law. Here, the law of North Carolina recognizes a valid contract whereby the parties have entered into a novation, creating a new promissory note and relinquishing all right to assert pre-existing claims, including the allegation of fraud contained in the prior complaint. Granting petitioners rights that they have expressly waived by contract would inject uncertainty into the binding effect of settlement agreements. Such a result finds no justification under the Bankruptcy Code or its attendant policies.

Promoting settlements of litigation is an important policy throughout our judicial system, but especially so in bankruptcy. Settlements in bankruptcy, including settlements of nondischargeability claims, play a crucial role in promoting judicial efficiency and maximizing debtor resources available to pay creditors. These same benefits flow from enforcing pre-bankruptcy settlements of the type at issue here. Any rule that would allow a creditor to resurrect earlier released claims of fraud would, to say the least, be disruptive of such settlements, and should not be endorsed absent compelling statutory grounds.

No such grounds can be found or derived from the language of the Bankruptcy Code. To the contrary, Section 523(a) itself contains two provisions in which Congress has expressly determined that settlements of specific types of claims can never render a debt dischargeable. Congress's express inclusion of such a restriction in other subsections of Section 523(a) cannot be squared with petitioners' contention that it should be included by inference in Section 523(a)(2).

Nor do petitioners' policy arguments provide a reason for refusing to enforce pre-bankruptcy settlement agreements in which a creditor agrees not to assert issues of fraud against a debtor. *First*, bankruptcy's policy of limiting the right of discharge to the "honest but unfortunate debtor" is not offended when, as here, the parties have expressly confronted the issue of fraud, resolved their differences, and agreed that the issue of fraud will not be raised again. On such facts, courts should accept the parties' conclusion that the claim of fraud is either wholly without merit or unworthy of pursuit, recognizing that the Code contains separate, explicit provisions for denying discharge to debtors who engage in egregious acts of fraud injurious to the interests of creditors and the bankruptcy process. *Second*, there is nothing tricky or treacherous in a rule that bankruptcy courts honor settlement agreements as they are written. Parties have a broad range of options as to the terms of their settlements, and it is their job (and that of their lawyers) to secure a settlement that will have the binding — or non-binding — effects they desire. *Finally*, petitioners' concern that a debtor may, to render them dischargeable, settle fraud claims for more than they are worth, thus allowing the claiming creditor to receive more than his fair share from the bankruptcy estate, is a hypothetical one of little practical moment. Further, as petitioners admit, this concern is already addressed by the Code's preferential transfer and fraudulent conveyance provisions.

ARGUMENT

I. PRINCIPLES OF COLLATERAL ESTOPPEL AND FEDERALISM COMPEL THE DECISION BELOW FORECLOSING THE ASSERTION OF FRAUD AS A BASIS FOR FINDING THE NOTE NONDISCHARGEABLE UNDER 11 U.S.C. § 523(a)(2)(A)

Collateral estoppel is an essential principle of American jurisprudence by which propositions of fact or law, once raised and necessarily decided by a final judgment on the

merits, become binding as between the same parties in all future disputes. *See, e.g.*, Restatement (Second) of Judgments § 27 (1982). This Court has made clear that this fundamental principle applies in the context of bankruptcy, so that prior judgments reached outside of bankruptcy will determine factual and legal issues that become relevant in bankruptcy. *See Grogan v. Garner*, 498 U.S. 279, 284 n.11 (1991) (collateral estoppel applies to determinations of dischargeability issues under Section 523(a)).[1] It is also clear under the Full Faith and Credit Statute, 28 U.S.C. § 1738, that federal courts, including bankruptcy courts, must give the same collateral-estoppel effect to prior state-court judgments that courts of that state would give them. On the facts of this case and under applicable North Carolina law, petitioners are collaterally estopped from asserting their claim that the debt for the outstanding note is nondischargeable under Section 523(a)(2). Accordingly, this Court should affirm the decision below.

A. The Parties' Settlement Resulted In A Final Judgment On The Merits That, Under The Governing North Carolina Law of Collateral Estoppel, Is Preclusive Against Petitioners On The Issue Of Fraud

1. Bankruptcy Courts Must Give State-Court Judgments The Same Preclusive Effect They Would Have Under That State's Law

Where the appropriate prerequisites for collateral estoppel are satisfied, the determination of "an issue of fact or law" in a prior litigation is "conclusive in a subsequent action between the parties on the same or a different claim." Restatement (Second) of Judgments § 27. Not only is this principle

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[1] *See also, e.g., In re Spigel*, 260 F.3d 27, 33 (1st Cir. 2001) (collateral estoppel applies in bankruptcy proceedings generally); *In re Cochrane*, 124 F.3d 978, 983 (8th Cir. 1997) (same); *In re Bulic*, 997 F.2d 299, 303 (7th Cir. 1993) (same).

generally applicable in bankruptcy, but in *Grogan* this Court "clarif[ied] that collateral estoppel principles do indeed apply in discharge proceedings pursuant to § 523(a)." 498 U.S. at 284 n.11, *see also Brown v. Felsen,* 442 U.S. 127, 139 n.10 (1979). Indeed, petitioners and the United States agree that a debtor "may invoke collateral estoppel to show that the debt is, or is not, nondischargeable." Pet. Br. at 15; *see* United States *Amicus* Br. at 20 n.3.

The Full Faith and Credit Statute, 28 U.S.C. § 1738, "requires federal courts to give the same preclusive effect to state court judgments that those judgments would be given in the courts of the State from which the judgments emerged." *Kremer v. Chem. Constr. Corp.*, 456 U.S. 461, 466 (1982). Thus, a "federal court [must] look first to state preclusion law in determining the preclusive effects of a state court judgment." *Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 381 (1985). If state preclusion law would bar relitigation of an issue, the federal court must accord the state judgment the same preclusive effect in a subsequent federal litigation "unless some exception to § 1738 applie[s]." *Id.*; *accord Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 375 (1996).

An exception to Section 1738 "will not be recognized unless a later statute contains an express or implied partial repeal" of that statute. *Kremer*, 456 U.S. at 468 (internal quotation marks omitted). The Bankruptcy Code contains no express repeal of Section 1738 as it pertains in the context of Section 523(a)(2). And this Court has "seldom, if ever, held that a federal statute impliedly repealed § 1738." *Matsushita*, 516 U.S. at 380. "[R]epeals by implication are not favored," *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 154 (1976) (internal quotation omitted), and any implied repeal of Section 1738 must rest on the "clear and manifest" intent of Congress. *Matsushita*, 516 U.S. at 380. Such intent might be shown by an "irreconcilable conflict" between Section 1738 and a later statute, or by the fact that a later statute "covers the whole

subject of the earlier one and is clearly intended as a substitute." *Kremer*, 456 U.S. at 468 (internal quotation marks omitted). Neither type of conflict arises in the case of the Bankruptcy Code.

In particular, "[n]o evidence of Congressional intent to create an exception to Section 1738 for dischargeability cases can be found in either the Bankruptcy Code or its legislative history." 18 *Moore's Federal Practice* § 132.03[2][k][iii][A] (3d ed. 1997). The fact that Congress placed the determination of nondischargeability issues within the exclusive jurisdiction of the bankruptcy courts does not support any such conclusion. As this Court made clear in *Matsushita*, exclusive federal jurisdiction over issues is not, in itself, a barrier to applying state preclusion law as commanded by Section 1738. 516 U.S. at 381-82 (exclusive federal securities law jurisdiction no basis for an exception); *accord Marrese*, 470 U.S. at 380 (exclusive federal antitrust jurisdiction no basis for an exception). This is so even though the application of state collateral-estoppel law may in practical terms be "'conclusive upon the [federal] question in issue.'" *Matsushita*, 516 U.S. at 384 (quoting *Becher v. Contoure Labs., Inc.*, 279 U.S. 388, 391 (1929)). Indeed, the Court in *Matsushita* cited *Brown v. Felsen*, 442 U.S. at 139 n.10, which noted that collateral-estoppel principles could establish that state-court litigation decided the issue of fraud against a creditor, as accepting this possibility. 516 U.S. at 384.

Thus, the application of state collateral-estoppel law is consistent with the grant of exclusive jurisdiction to the bankruptcy court to determine nondischargeability. Section 1738 merely requires a bankruptcy court to determine that question while giving due preclusive effect to prior litigation of common-law fraud (which is the same as fraud under

Section 523(a)(2), *see Field v. Mans*, 516 U.S. 59, 70 (1995)) in state-court proceedings.[2]

Finally, *Matsushita* held that application of state-law collateral estoppel is proper even if, as here, the relevant state-court judgment is entered pursuant to a settlement between the parties. *Matsushita* involved a judgment based on a settlement of state-court litigation and held that Section 1738 "mandate[s] full faith and credit of state court judgments incorporating global settlements, provided the rendering court had jurisdiction over the underlying suit itself." 516 U.S. at 385. As with the Securities and Exchange Act at issue in *Matsushita*, there is no suggestion in the Bankruptcy Code that "Congress meant for plaintiffs . . . to have more than one day in court" to establish a fraud claim. *Id.* at 381.

Accordingly, every federal court of appeals to consider this issue has held that state collateral-estoppel law applies when determining the preclusive effect of a state judgment in a

[2] Nor is partial repeal of Section 1738 suggested by the purposes motivating Congress's grant of exclusive jurisdiction to bankruptcy courts to address dischargeability issues. The "primary purpose" for granting exclusive jurisdiction to the bankruptcy court was to protect unrepresented debtors against abuse by creditors seeking nondischargeability orders in *post*-bankruptcy, state-court actions. *Brown*, 442 U.S. at 135-36. Certainly this objective is not offended by affording the usual collateral-estoppel effect to *pre*-bankruptcy state-court settlement judgments foreclosing creditor claims. The "secondary purpose" of concentrating nondischargeability decisions was to allow bankruptcy courts to "develop expertise" in handling such issues. *Id.* Likewise, this objective is wholly consistent with adherence to the usual principles of collateral estoppel and federalism. *See Matsushita*, 516 U.S. at 384.

nondischargeability proceeding.[3] Leading commentators agree that this is the correct result.[4]

2. The North Carolina Settlement Resulted In A Judgment On The Merits That Is Preclusive Against Petitioners On The Issue Of Fraud, As Fraud Is Defined In 11 U.S.C. § 523(a)(2)(A)

Under North Carolina law, a "final judgment on the merits prevents relitigation of issues actually litigated and necessary to the outcome of the prior action in a later suit involving a different cause of action between the parties." *Thomas M. McInnis & Assocs., Inc. v. Hall*, 349 S.E.2d 552, 557 (N.C. 1986) (citing Restatement (Second) of Judgments § 27). Thus, a party who invokes collateral estoppel must show that "the earlier suit resulted in a final judgment on the merits, that the issue in question was identical to an issue actually litigated and necessary to the judgment, and that [both parties to the present case] were either parties to the earlier suit or were in privity with parties." *Id.*

The parties to the Section 523(a) nondischargeability proceeding were all parties to the North Carolina litigation.

[3] *See In re Spigel*, 260 F.3d 27, 33 (1st Cir. 2001); *In re Bogdanovich*, 292 F.3d 104, 110 (2d Cir. 2002); *In re Brown*, 951 F.2d 564, 568-69 (3d Cir. 1991); *In re McNallen*, 62 F.3d 619, 624 (4th Cir. 1995); *In re Caton*, 157 F.3d 1026, 1027 (5th Cir. 1998); *In re Calvert*, 105 F.3d 315, 317 (6th Cir. 1997); *In re Bulic*, 997 F.2d 299, 304 n.6 (7th Cir. 1993); *In re Madsen*, 195 F.3d 988, 989 (8th Cir. 1999); *In re Harmon*, 250 F.3d 1240, 1245 (9th Cir. 2001); *In re Laing*, 945 F.2d 354, 358 (10th Cir. 1991); *In re St. Laurent*, 991 F.2d 672, 675-76 (11th Cir. 1993).

[4] *See, e.g.*, 18B C. Wright, *et al.*, *Federal Practice & Procedure* § 4470.3 (2d ed. 2002) ("The exclusive bankruptcy jurisdiction does not imply repeal [of Section 1738]."); W. Norton, *Norton Bankruptcy Law and Practice* § 47:72 (2d ed. 2002) ("The better view is to apply the same collateral estoppel effect to a judgment as would the court issuing the judgment."); C. Tabb, *The Law of Bankruptcy* § 1.14, at 60 (1997) ("State law is important [in nondischargeability proceedings] because a bankruptcy will give collateral estoppel effect to litigation in state court.").

Furthermore, there is no question that the North Carolina suit ended in a final judgment on the merits on the issue of fraud, which was actually litigated in that action and necessarily decided against petitioners by the judgment. Under North Carolina law, where a "plaintiff file[s] a Stipulation of Dismissal with Prejudice," that action "constitutes a final judgment on the merits" which "'preclude[s] subsequent litigation to the same extent as if the action had been prosecuted to a final adjudication adverse to the plaintiff.'" *Miller Bldg. Corp. v. NBBJ North Carolina, Inc.*, 497 S.E.2d 433, 434-35 (N.C. Ct. App. 1998); (quoting *Barnes v. McGee*, 204 S.E.2d 203, 205 (N.C. Ct. App. 1974)); *accord Bailey v. Gitt*, 518 S.E.2d 794, 795 (N.C. Ct. App. 1999); *Caswell Realty Assocs. v. Andrews Co.*, 496 S.E.2d 607, 611 (N.C. Ct. App. 1998).

This is so even "'if the rendering court made no express findings on issues raised by the pleadings or the evidence'" because "'the court may infer that in the prior action a determination appropriate to the judgment rendered was made as to each issue that was so raised.'" *Miller Bldg.*, 497 S.E.2d at 435 (quoting 18 *Moore's Federal Practice* § 132.03 [4][i] (3d ed. 1997)). "[T]he dismissal 'with prejudice' . . . therefore constitutes an adjudication of those issues against the plaintiff," and a subsequent court must find that identical issues raised in the second action "are barred by collateral estoppel." *Miller Bldg.*, 497 S.E.2d at 435; *see also Caswell Realty*, 496 S.E.2d at 611 ("voluntary dismissal with prejudice" combined with "sufficient identification" of issues "call[s] the doctrine of res judicata and/or collateral estoppel into play"); *NationsBank of North Carolina v. Am. Doubloon Corp.*, 481 S.E.2d 387, 393 (N.C. Ct. App. 1997) (consent judgment is a final judgment that carries collateral estoppel effect); *Nash Cty. Bd. of Educ. v. Biltmore Co.*, 640 F.2d 484, 486-87 (4th Cir. 1981) (same; applying N.C. law).

Thus, it is true in North Carolina, as under the decisions of this Court, that a final judgment based on an express

stipulation of fact, or, as here, an express relinquishment of claims with prejudice, satisfies the "actually litigated" prerequisite to collateral estoppel. *See Matsushita*, 516 U.S. at 385-86. Otherwise, parties could never finally resolve disputed issues without an actual judicial fact finding, a result that would be at odds with common sense and the long-standing rule that "a judgment entered by confession, consent, or default . . . may be conclusive . . . with respect to one or more issues, if the parties have entered an agreement manifesting such an intention." Restatement (Second) of Judgments § 27 cmt. e. *See also* 18 *Moore's Federal Practice* §§ 132.03[2][h][i], [2][k][ii] (stipulations and consent judgments carry collateral-estoppel effect if the parties so intend); F. James, *Consent Judgments as Collateral Estoppel*, 108 U. Pa. L. Rev. 173, 188 (1959) (same).[5]

The only basis on which to avoid this conclusion under North Carolina law is by showing that a party "was denied an opportunity to litigate these issues in the first case." *Miller Bldg.*, 497 S.E.2d at 435. But no such showing can be made here. Petitioners' action proceeded in Guilford County Superior Court for almost three years. The parties conducted substantial discovery and engaged in lengthy settlement negotiations. Those negotiations culminated in a settlement agreement and two releases, the import of which was to

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[5] Federal courts, in a variety of contexts, repeatedly have applied this rule and assigned collateral-estoppel effect to stipulations and settlements where the parties intended such a result. This intent is evidenced by a discharge and general release with prejudice of all claims. *See, e.g., In re Berr*, 172 B.R. 299, 304 (B.A.P. 9th Cir. 1994); *Foster v. Hallco Mfg. Co.*, 947 F.2d 469, 480-81 (Fed. Cir. 1991); *Barber v. Int'l Bhd. of Boilermakers*, 778 F.2d 750, 757-58 (11th Cir. 1985); *Green v. Ancora-Citronelle Corp.*, 577 F.2d 1380, 1383 (9th Cir. 1978); *Yachts Am., Inc. v. United States*, 673 F.2d 356, 361-63 (Ct. Cl. 1982). This Court has acknowledged the rule in other cases, but, on the particular facts of those cases, found no evidence that the parties intended their settlement to carry preclusive effect. *See Arizona v. California*, 530 U.S. 392, 414 (2000); *Lawlor v. Nat'l Screen Serv. Corp.*, 349 U.S. 322, 327 & n.12 (1955); *United States v. Int'l Bldg. Co.*, 345 U.S. 502, 505-06 (1953).

release all rights, including the right to assert fraud against respondent, in exchange for delivery of $200,000 in cash and a secured note for $100,000. The agreements expressly provided that plaintiffs would "dismiss the complaint with prejudice . . . forthwith," J.A. 63, 71, thus evidencing an unmistakable intention to finally resolve the fraud issues in a binding manner. *Cf. Cudmore v. Howell*, 232 B.R. 335, 338-40 (E.D.N.C. 1999) (under North Carolina law, default fraud judgment against debtor carried collateral-estoppel effect in Section 523(a) nondischargeability proceeding where debtor filed an answer, engaged in settlement negotiations, and had a full and fair opportunity to litigate his claims in state court).

Nor is there any question that the theory of fraud pleaded in petitioners' nondischargeability complaint is identical to the theory of fraud pleaded — and finally resolved — in the North Carolina action. As the court below expressly noted, petitioners' bankruptcy-court pleading offered as grounds for nondischargeability only the allegations contained in the North Carolina complaint, which were simply incorporated by reference. Pet. App. 4a.

Moreover, both the elements of fraud and the burden of proof required of a fraud plaintiff under North Carolina law are identical to those required of a creditor under Section 523(a)(2)(A). In North Carolina, the elements of a fraud claim track the standard elements of fraud set forth in the Restatement (Second) of Torts. *See, e.g., Rowan Cty. Bd. of Educ. v. United States Gypsum Co.*, 407 S.E.2d 860, 863 (N.C. Ct. App. 1991). *See also Cofield v. Griffin*, 78 S.E.2d 131, 134 (N.C. 1953) (applying same elements of fraud from Restatement (First) of Torts). Specifically, a North Carolina fraud claim requires a "misrepresentation" made with "knowledge of its falsity" and with "intention" that it be relied upon, a party's "reasonable" reliance, and injury. *Horack v. S. Real Estate Co. of Charlotte, Inc.*, 563 S.E.2d 47, 53 (N.C. Ct. App. 2002); *Becker v. Graber Builders, Inc.*, 561 S.E.2d 905, 910 (N.C. Ct. App. 2002).

Likewise, fraud under Section 523(a)(2)(A) "incorporate[s] the general common law of torts." *Field*, 516 U.S. 59 at 70 n.9 (1995). Specifically, the Court in *Field* referenced the Restatement (Second) of Torts as the "most widely accepted distillation of the common law of torts." *Id.* at 70. The Restatement defines fraud as a "misrepresentation" that the maker "knows" is false, "intention . . . of inducing another to act," "justifiable reliance" upon the misrepresentation, and injury. Restatement (Second) of Torts §§ 525, 526. And this Court emphasized in *Field* that, even though the reliance element in fraud claims under North Carolina law is often stated as "reasonable reliance," it is, in its application, the same as the "justifiable reliance" standard applied under Section 523(a)(2)(A). 516 U.S. at 73-74 & n.12 (citing *Johnson v. Owens*, 140 S.E.2d 311, 314 (N.C. 1965)).[6]

Finally, a fraud plaintiff's burden of proof under North Carolina law is identical to the creditor's burden under Section 523(a)(2). Under North Carolina law, a plaintiff bears the burden of proving fraud "not beyond a reasonable doubt, nor even by clear and convincing proof, but by a preponderance of the testimony and to the satisfaction of the jury." *Dare Cty. v. Smith Const. Co.*, 67 S.E. 37, 38 (N.C. 1910); *accord, e.g., Hodges v. Wilson*, 81 S.E. 340, 343 (N.C. 1914). Section 523(a) likewise requires "the creditor to establish by a preponderance of the evidence that his claim is not dischargeable" because it is based on a debt obtained by fraud. *Grogan*, 498 U.S. at 287.

Accordingly, the parties' settlement resolution of this case, evidencing a clear intention to foreclose future assertions of

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[6] *See also Marcus Bros. Textiles, Inc. v. Price Waterhouse, LLP*, 513 S.E.2d 320, 327 (N.C. 1999) (the "question of justifiable reliance is analogous to that of reasonable reliance in fraud actions") (internal quotation marks omitted); *Rowan Cty. Bd. of Educ.*, 407 S.E.2d at 863 ("Recovery in fraud also requires justifiable reliance by the plaintiff in acting or refraining from action because of the defendant's fraudulent misrepresentation.").

fraud against respondent, and embodied in a final judgment of the North Carolina court, carries collateral-estoppel effect in North Carolina as to the claims and issues thus finally resolved. The fraud claim resolved in North Carolina is identical to the fraud claim asserted in the bankruptcy court, and this Court's cases mandate that North Carolina's law of collateral estoppel governs. As a result, petitioners may not assert fraud as a ground for nondischargeability under Section 523(a).

B. This Conclusion Is Fully Consistent With This Court's Decision In *Brown v. Felsen*, Which Held That *Res Judicata* Does Not Foreclose Contentions Supporting Claims Of Nondischargeability That Might Have Been Resolved In A Prior Proceeding, But Were Not

Applying collateral estoppel to prevent petitioners from relitigating their fraud claims is entirely consistent with *Brown v. Felsen*, 442 U.S. 127 (1979). There, the debtor and creditor had reached a stipulated settlement of litigation, incorporated into a consent judgment, that specified the amount owed by the debtor to the creditor, but omitted any statement of the legal theory on which that money was agreed to be owing. When the debtor declared bankruptcy, the creditor filed a claim of nondischargeability on the ground that the agreed amount of the debt arose from fraud by the debtor. The debtor argued that this assertion was barred by *res judicata*.

This "res judicata claim [was] unlike those customarily entertained by the courts." 442 U.S. at 132. The debtor argued that the consent judgment, though favorable to the creditor and fully consistent with the claim that the debtor had committed fraud, nonetheless foreclosed the creditor from asserting fraud under Section 523(a) because the judgment did not finally determine that the debtor had, in fact, committed fraud. *Id.* at 134. Under the debtor's view, the earlier state court proceeding was "the appropriate forum for resolving all

debtor-creditor disputes, including those concerning dischargeability." *Id.*

This Court rejected this *res judicata* argument because it would have forced creditors litigating claims in state court "to try [nondischargeability] questions to the hilt in order to protect [themselves] against the mere possibility that a debtor might take bankruptcy in the future," even if the creditor could win his state-court claim without ever resolving those issues. 442 U.S. at 135. Any such result "would undercut Congress' intention to commit [nondischargeability] issues to the jurisdiction of the bankruptcy court." *Id.* The Court thus refused to "resolve a federal dischargeability question according to whether or not the parties in state court waived their right to engage in hypothetical litigation in an inappropriate forum." *Id.* at 137.

In contrast, petitioners here are attacking a prior state-court judgment and settlement that, under the collateral-estoppel law of North Carolina, resolved all issues of fraud against them. *Brown* itself expressly distinguished between its refusal to recognize *res judicata* as foreclosing all theories that might have been raised in the prior proceeding (but were not), and "collateral estoppel [which] treats as final only those questions actually and necessarily decided in a prior suit." 442 U.S. at 139 n.10. *Brown* allowed for the possibility that collateral estoppel might apply to nondischargeability issues. *Id.* In *Grogan*, the Court held expressly that it does. 498 U.S. at 284 n.11.

Nor is there any incongruity between *Brown* and *Grogan*. Where a prior judgment is collateral estoppel on the issue of fraud, that issue necessarily has been confronted by the parties and resolved on the merits, based on either a factfinding or an agreement of the parties. Foreclosing future litigation of the issue on that ground is far different than doing so on the ground that the issue of fraud was waived because it was never resolved one way or the other in the prior proceeding. Here, the issue of fraud was squarely presented in the North

Carolina proceedings and finally resolved by a settlement and dismissal with prejudice that clearly implemented the express intentions of the parties — to extinguish the fraud claim for all time. The same was not true in *Brown*, where the parties agreed to the entry of judgment for the creditor but simply left unaddressed the issue of fraud.

II. WHILE COLLATERAL ESTOPPEL PLAINLY COMPELS THE RESULT REACHED BY THE COURT OF APPEALS, THIS COURT SHOULD AFFIRM ON THE BROADER GROUND THAT BANKRUPTCY COURTS MUST GENERALLY GIVE EFFECT TO CONTRACTS ENFORCEABLE UNDER STATE LAW BY WHICH LITIGANTS AGREE TO REFRAIN FROM MAKING PARTICULAR ALLEGATIONS IN THE FUTURE

Under the facts of this case, application of well-established principles of collateral estoppel requires affirmance of the decision below. All issues of fraud arising from the sale of Archer Manufacturing to petitioners have been resolved against petitioners by the judgment on the merits that resulted from voluntary dismissal of all pending claims with prejudice.

Plainly, though, the foundation of that stipulated judgment, and of its collateral-estoppel effect, is the agreement of the parties to resolve their dispute on terms that included the permanent and irrevocable release of plaintiffs' fraud claim. *See* pp. 15-20 *supra*. Respondent submits that because the parties entered into a settlement contract enforceable under state law, the same result should obtain even if the agreement of the parties had never been accompanied by a final judgment on the merits. On this basis, the courts below correctly rejected petitioners' nondischargeability claim on the basis of the contract that petitioners willingly entered into with respondent. The absence of a judgment, which is present here and is of course necessary for the application of collateral estoppel, should not allow a creditor who agrees not to assert fraud against a debtor to escape his bargain in the context of

a Section 523(a)(2) nondischargeability proceeding. On this basis, the decisions below are entirely correct not only in result reached, but in their reasoning as well.

A. State Law Defines The Property Rights Of A Creditor Against The Estate In Bankruptcy, And Petitioners' Sole Rights Are Those That They Retain Under Their Contract With Respondent

The "basic federal rule" in bankruptcy is that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Butner v. United States*, 440 U.S. 48, 54 (1979); *accord, e.g, Raleigh v. Illinois Dep't of Rev.*, 530 U.S. 15, 20 (2000). Absent "some federal interest requir[ing] a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner*, 440 U.S. at 55. Identical treatment of property interests in both federal and state courts serves several interests: "[T]o reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" *Id.* (quoting *Lewis v. Mfrs. Nat'l Bank*, 364 U.S. 603, 609 (1961)).

Petitioners' rights against respondent's assets, therefore, principally are determined by the law of North Carolina. Under that law, the release that petitioners granted respondent is a contract that, when "based on valuable consideration," *Talton v. Mac Tools, Inc.*, 453 S.E.2d 563, 565 (N.C. Ct. App. 1995), "is usually held to discharge all and sundry claims between the parties." *McGladrey, Hendrickson & Pullen v. Syntek Fin. Corp.*, 375 S.E.2d 689, 691 (N.C. Ct. App. 1989). *See also Merrimon v. Postal Telegraphcable Co.*, 176 S.E. 246, 248 (N.C. 1934) (contractual releases "buy peace from all future contention on then existing claims of every character"). Like any other contract, a release "is subject to avoidance by a showing that its execution resulted from fraud or mutual mistake." *Sykes v. Keiltex Indus., Inc.*, 473 S.E.2d

341, 344 (N.C. Ct. App. 1996). But petitioners do not argue before this Court that the release they signed suffers from any such defect. Pet. Br. 8 n.5.

Petitioners contracted to release respondent from "from any and every right . . . relating to the matter of the litigation in Guilford County Superior Court . . . excepting only obligations under a Note and deeds of trust executed contemporaneously herewith." J.A. 67. Under North Carolina law, this release contract was valid and, by its plain language, bought respondent peace from all future contentions that she had engaged in fraudulent conduct during the sale of Archer Manufacturing. The agreement is a "novation" that extinguished all previous obligations and claims and created a new obligation in the form of a $100,000 promissory note. *See, e.g., Tomberlin v. Long*, 109 S.E.2d 365, 368 (N.C. 1959) ("Novation implies the extinguishment of one obligation by the substitution of another." (internal quotation marks omitted)); *accord, e.g, Wilson v. McClenny*, 136 S.E.2d 569, 576 (N.C. 1964). Thus, petitioners come to federal court holding only such rights against respondent's estate as are spelled out in the contract and enforceable under state law — here, "to enforce the holder's rights and remedies . . . as provided in this Note." J.A. 74-75 (emphasis added).

Petitioners contend that they must be allowed to reassert their extinguished allegation of fraud for the purpose of showing that the note represents a debt for "money . . . obtained by . . . false pretenses, a false representation, or actual fraud," and is therefore nondischargeable. 11 U.S.C. § 523(a)(2)(A). But allowing petitioners to thus renew their claim of fraud would violate their contract and run directly counter to the principle identified in *Butner* of limiting creditors to their rights against the debtor's estate as defined by state law. As suggested in *Butner*, 440 U.S. at 55, such a course would inject tremendous uncertainty into the binding effect of validly-formed contracts that, at state law, would preclude creditors from raising issues of fraud. Moreover,

such a rule would provide a "windfall" to the creditor "merely by reason of the happenstance of bankruptcy," *id.*, since an extinguished allegation of fraud would thereby be given a second life. By releasing creditors from the burden of their bargain, while allowing them to retain its benefits, petitioners' interpretation of the Code would thus undermine state contract law in an important way.

B. This Conclusion Is Supported By The Important Role Of Private Settlements In The Context Of Bankruptcy

"[P]ublic policy wisely encourages settlements." *McDermott, Inc. v. AmClyde*, 511 U.S. 202, 215 (1994). This is true in the specific context of bankruptcy as well. Compromises and settlement agreements are authorized by Rule 9019(a) of the Federal Rules of Bankruptcy Procedure, and are "favored in bankruptcy." 10 L. King, ed., *Collier on Bankruptcy* ¶ 9019.031 (15th ed. 1993). The role of settlement in bankruptcy extends to compromise of creditors' actions "to have a particular debt declared nondischargeable." S. Snyder & L. Ponoroff, *Commercial Bankruptcy Litigation* § 9.12[3], at 9-121 (25th ed. 2002). *See also* L. LoPucki, *Strategies for Creditors in Bankruptcy Proceedings* § 6.06[H] (3d ed. 1997). This type of settlement is explicitly recognized in the Advisory Committee Note to Bankruptcy Rule 4004(c), which acknowledges that a bankruptcy court may defer the entry of the order granting a debtor's general discharge, because "[i]mmediate entry of that order . . . may render it more difficult for a debtor to settle pending litigation to determine the dischargeability of a debt and execute a reaffirmation agreement as part of a settlement." Fed. R. Bankr. P. 4004(c) advisory committee's note.

"The courts are uniform in their respect, desire, and appreciation of settlements in a bankruptcy case." R. Valencia, *The Sanctity of Settlements and the Significance of Court Approval: Discerning Clarity from Bankruptcy Rule 9019*, 78 Or. L. Rev. 425, 430 (1999). Indeed, "[t]he glue that

often holds the bankruptcy process together is the ability of parties to resolve disputes by settlement instead of litigation. If bankruptcy judges had to try a much larger percentage of matters than they currently do, the system would surely bog down." L. Clark, *Symposium Survey: Bankruptcy*, 28 Tex. Tech L. Rev. 299, 324 (1997). This Court has emphasized the important, even crucial, role that settlements play in the efficient operation of the bankruptcy process. *See Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc. v. Anderson*, 390 U.S. 414, 424 (1968) ("In administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts."); *Gardner v. New Jersey*, 329 U.S. 565, 581 (1947) ("compromise or settlement of claims" in bankruptcy is favored so that "interminable litigation might be ended and the interests of expedition in promulgating a plan of reorganization served").

These same policies that make settlements negotiated during bankruptcy important to the effective working of that process support recognition of settlements negotiated pre-bankruptcy. Of course, litigation that has been settled need not be tried in the bankruptcy court, and this conservation of judicial resources is no small matter. But the resources of the parties also will be conserved and, especially where a defendant ends up in bankruptcy, settlement may be the only means of resolving litigation in a way that does not consume most or all of the available resources. *See* LoPucki, *supra*, § 6.06(H), at 291-92 ("If the debt is not more than a few thousand dollars, the attorney's fees that would be incurred by each side in order to submit the matter for a judicial determination would probably exceed the amount truly in controversy.").

There can be no doubt that the ability of parties to settle a dispute is reduced by legal restrictions on the terms of a permissible settlement. *See United States v. Mezzanatto*, 513 U.S. 196, 208 (1995) ("[A]s a logical matter, it simply makes

no sense to conclude that mutual settlement will be encouraged by precluding negotiation over an issue that may be particularly important to one of the parties to the transaction."). Any rule that would prevent a potential plaintiff from relinquishing particular claims in a way that will bind him in the future would obviously make settlement of at least those claims impossible. Petitioners' approach here would apparently allow a claimant to agree that there has been no fraud, and, by making his intent clear, bind himself by a settlement judgment that would bar a new fraud suit in the future. But they would deny that settlement its binding effect in foreclosing assertions of the same fraud, when offered in the context of determining nondischargeability under Section 523(a)(2)(A).[7]

Such a bar to a party's ability to forswear categorically the making of a particularly inflammatory allegation — such as fraud — is odd, and radically changes the terms of the bargain that might otherwise have been struck. It is odd, because not every thought that passes through the mind of a potential plaintiff, or finds its way into a complaint, demands a judicial resolution. Normally, we take the plaintiff's word for it, and let drop an allegation if the aggrieved party concludes that it should no longer be pursued, for whatever reason. Refusing to do so — and keeping the innuendo of fraud alive to be revived in bankruptcy in the context of Section 523(a) — will certainly make the prospect of settlement on any specified terms less attractive to the defendant, and may on some facts prevent any settlement from being reached. Such a disruption

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[7] Contrary to petitioners' contention, Pet. Br. 21-22, once the issue of fraud is determined by settlement in a manner that is preclusive of all issues on which dischargeability depends, there is no separate issue of "nondischargeability" remaining to be resolved. Nondischargeability under Section 523(a)(2)(A) turns upon a showing that a debt is for money "obtained by . . . fraud." While the bankruptcy court has exclusive jurisdiction to make the ultimate determination of nondischargeability, that does not suggest that it can or must ignore the disposition of the underlying fraud issue reached by the parties.

of the settlement process and denial of the freedom to relinquish claims — and thus end disputes — should not be allowed absent compelling statutory grounds.

Nothing in the Bankruptcy Code's provisions calls for this result. To the contrary, when Congress intends to preclude a debtor from obtaining a discharge of a debt evidenced by settlement, it specifically so states. Section 523(a)(11) renders nondischargeable a debt "provided in any final judgment . . . entered in any court . . . , issued by a Federal depository institutions regulatory agency, *or contained in any settlement entered into by the debtor*, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." (emphasis added). In recent weeks, as part of the Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002), Congress added a new Section 523(a)(19) to the Code, which renders nondischargeable debts for "violation of any of the Federal securities laws, . . . or common law fraud, deceit, or manipulation in connection with the purchase or sale of any security" that result from "any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding" or "*any settlement agreement entered into by the debtor*." (emphasis added).

"[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Gozlon-Peretz v. United States*, 498 U.S. 395, 404 (1991); *accord Russello v. United States*, 464 U.S. 16, 23 (1983). That presumption is warranted here. In Sections 523(a)(11) and (a)(19), Congress has concluded that certain types of alleged misconduct are such that no settlement of those allegations can be allowed to render the resulting debt dischargeable. *See, e.g.*, 136 Cong. Rec. H13288, 13289 (daily ed. Oct. 27, 1990) (statement of Rep. Brooks) (Section

523(a)(11) was "narrowly crafted to hit only those who committed the worst abus[e]"); S. Rep. No. 107-146, at 16 (Section 523(a)(19) designed to close a "loophole" and "help defrauded investors recoup their losses"). And Congress plainly viewed these amendments as adding to other provisions of the Bankruptcy Code, such as Sections 523(a)(2) and (a)(4), which define broader categories of debts that already encompass those arising from the substantive conduct addressed by Sections 523(a)(11) and (19).

If, as petitioners contend, Section 523(a) categorically required that settlements be ignored for purposes of determining nondischargeability in bankruptcy, then the references in Sections 523(a)(11) and (a)(19) to settlements would be superfluous. As this Court has held, it is improper to read one subsection of Section 523(a) in a way that "would obviate the need for" another subsection that Congress has enacted. *Kawaauhau v. Geiger*, 523 U.S. 57, 61 (1998) (courts are "hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of the same law" (internal quotation marks omitted)); *see also Meyer v. Rigdon*, 36 F.3d 1375, 1380 (7th Cir. 1994) (employing same rule in construing Section 523(a)(11)). In fact, these amendments are not mere surplusage, but rather show that when Congress wishes to afford settlements a disfavored status in nondischargeability proceedings, and thereby force debtors who wish to avoid nondischargeability to litigate a fraud allegation to its conclusion, Congress does so explicitly.

In summary, if adopted, petitioners' view that settlements in which a creditor agrees to relinquish claims of fraud for all time should be ignored in bankruptcy would result in more cases of alleged fraud being litigated to conclusion, since that would be the only way for the debtor to achieve real finality on the fraud allegation. No language in the Bankruptcy Code suggests that settlements should be given this disfavored status. In fact, language in the Code signals precisely the

contrary — that settlements are, if anything, more important to the working of the bankruptcy process than elsewhere in our courts and are ignored in determining dischargeability issues only when Congress explicitly so states.

C. Petitioners' Policy Arguments Do Not Justify A Special Bankruptcy Rule That Would, As A General Matter, Deny The Effect Of Settlements In The Context Of Nondischargeability Issues

There being no specific provisions of the Bankruptcy Code supporting their proposed rule ignoring the effect of settlements in the context of Section 523(a)(2) proceedings, petitioners resort to a series of policy arguments to make their case. These arguments fall far short of justifying petitioners' proposed rule.

1. The Principle That Bankruptcy Discharge Is Intended To Assist Only "Honest But Unfortunate Debtors" Does Not Support The Rule Petitioners Advocate

Petitioners argue that bankruptcy policy, expressed in several of this Court's decisions, favoring the honest but unfortunate debtor with the opportunity to have his debts discharged is inconsistent with allowing creditors to relinquish by settlement fraud claims, and thus render their settlement rights dischargeable. Petitioners allege that allowing creditors to settle their disputes in a manner preclusive of nondischargeability claims "would have potentially wide ranging consequences throughout bankruptcy law, and [would] threaten[] to open a gaping hole in [the Supreme Court's] repeated admonition that [] discharge is available only to the 'honest but unfortunate' debtor." Pet. 10.

There are several answers to this contention. First, the fact that parties have squarely confronted the issue of fraud, voluntarily resolved their differences, and agreed not to raise issues of fraud again means that for all relevant purposes, on the say-so of the parties most directly concerned, there was no

fraud. Taking that finding at face value, as we must, there is no offense to the honest but unfortunate debtor principle. Thus, as discussed above, *see* pp. 21-23 *supra*, *Brown*'s concern that a waiver theory not preclude examination of a debtor's conduct when an issue of fraud was never resolved one way or the other simply is not implicated.

Given that the parties have agreed that there have been no acts of fraud worthy of further pursuit, enforcement of the settlement agreement as written is fully consistent with this Court's decisions in *Cohen* and *Grogan*, each of which relied upon the Bankruptcy Code's policy of affording relief to the "honest but unfortunate debtor." *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998); *Grogan*, 498 U.S. at 287. These cases cited this policy in support of giving Section 523(a)(2) broad reach where fraud already has been proven, *Cohen*, 523 U.S. at 221-22, and of rejecting an increased burden of proving fraud under Section 523(a)(2) by clear and convincing evidence, *Grogan*, 498 U.S. at 287-88. But neither case concerns the antecedent question, presented in this case, of whether a bankruptcy court fraud inquiry is proper in the first place. Certainly, neither case suggests that the "honest but unfortunate debtor" policy forces a bankruptcy court to override a creditor's voluntary agreement, contained in a settlement contract, not to assert issues of fraud against a debtor.[8]

Indeed, the Bankruptcy Code itself provides that, unlike other potentially nondischargeable debts, a debt may be ruled nondischargeable under Section 523(a)(2) only if a creditor

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[8] Petitioners admit (Pet. Br. 25) that those cases disallowing pre-bankruptcy contracts concerning nondischargeability have done so only when a debtor stipulates that a debt will not be discharged. These cases rest on the traditional solicitude shown in bankruptcy to the debtor's right to a fresh start. *See* 11 U.S.C. § 524. Petitioners cite no case, and respondent has found none, suggesting that a creditor and debtor are somehow barred from reaching an enforceable pre-bankruptcy contract whose terms prevent the creditor from asserting fraud against the debtor.

requests a dischargeability hearing, and does so within 60 days after the first date set for the meeting of creditors. 11 U.S.C. § 523(c)(1); Fed. R. Bankr. P. 4007(c). Absent such a timely affirmative request, the Code thus contemplates that a nondischargeability claim will be lost, quite apart from any express agreement to relinquish it. Thus, presumably, creditors may choose, for any reason or no reason, to forgo an assertion of nondischargeability under Section 523(a)(2). There is no suggestion anywhere in the Code that the bankruptcy court has either the power or the duty to override that choice — or the choice to relinquish such a claim by contract — by initiating its own fraud inquiry to smoke out a "dishonest" debtor. To the contrary, courts construe the procedural requirements for a Section 523(a)(2) claim strictly against creditors. *See* 5 *Collier on Bankruptcy* ¶ 523.26[1].

At the same time that the Code thus leaves it to each creditor to determine whether to pursue a claim of non-dischargeability under § 523(a)(2), other provisions address directly the concern that dishonest debtors may misuse the bankruptcy process to their own advantage. In particular, Section 727(a) sets out ten separate grounds on which the bankruptcy court may conclude that the debtor should be denied any discharge at all. 11 U.S.C. § 727(a)(1) - (10). Under those provisions, on motion of the trustee, a creditor, or the United States Trustee, *see id.* § 727(c)(1), the bankruptcy court may deny any discharge to a debtor who commits any of a broad range of acts in the nature of fraud on the bankruptcy process, or upon his creditors, beginning one year before the filing of bankruptcy. *See id.* § 727(a)(2)(A). These provisions overcome the law's preference for discharge in bankruptcy where the debtor has engaged in "'intentional departure from honest business practices where there is a reasonable likelihood of prejudice.'" 6 *Collier in Bankruptcy* ¶ 727.01[4] (quoting *Kentile Floors, Inc. v. Winham*, 440 F.2d 1128, 1131 (9th Cir. 1971)).

The Code thus is entirely coherent and strikes a sensible balance in declining to second guess the litigation decisions of creditors to settle or abandon their claims, while creating a powerful tool in Section 727(a) to address egregious dishonesty carrying adverse consequences for the bankruptcy system and the creditors.

2. There Is Nothing Tricky Or Treacherous About Applying The Usual Rules Of Contract Interpretation To Preclude Further Assertion Of Contentions That Were Expressly Relinquished By A Prior Settlement

Petitioners and their *amici* rely (Pet. Br. 22-23; AARP *Amicus* Br. 6; Ohio *Amicus* Br. 10-11) on the suggestion that there is something tricky or treacherous about letting the dischargeability of claims be governed by settlements that may be binding against a creditor on the issue of fraud, and that there is a corresponding high likelihood that innocent people will somehow be taken advantage of. This is a highly exaggerated concern. As the district court noted, Pet. App. 24a, parties considering settlement of a fraud claim have a broad range of options as to the terms of any settlement.

Since the issue in any later bankruptcy may be whether the debt arose by fraud, the parties might resolve their case on the express understanding that the debt did, in fact, arise from fraud committed against the creditor. The result should be to bind the parties to that resolution of the fraud issue, and lead a bankruptcy court to rule that the debt is nondischargeable. Alternatively, the parties might (as they did here) include in their settlement language expressly releasing any fraud claim, thereby rendering settlement rights dischargeable in bankruptcy. Or, the parties could stipulate that no claims are released until such time as full payment is made of the obligations under the settlement with the result that the fraud claim remains unresolved and open to litigation by the bankruptcy court. These are only some of the options open to the parties, who are the masters of their own settlement

agreement. Their job, and that of their lawyers, is to secure a settlement that will have the binding — or non-binding — effects that they mutually desire.[9]

3. Refusal To Enforce A Settlement According To Its Terms Cannot Be Justified As Necessary To Protect Other Creditors

Petitioners express concern that allowing creditors to negotiate settlements in advance of bankruptcy could impair the rights of other creditors who are not parties to the agreement. Pet. Br. 24. Specifically, petitioners worry that a debtor may be motivated to settle claims for more than they are fairly worth, in order to turn them into dischargeable claims, and in the process allow the claiming creditor to receive more than his share from the bankruptcy estate. *Id.* at 26.

This marginal concern hypothesizes a debtor who, in a premeditated manner, sees his own impending bankruptcy ahead, contemplates the risk of a given claim being found to be nondischargeable, and then negotiates a settlement

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[9] It is noteworthy that the examples given by petitioners' *amici* do not support their contention that affirming the decision below will cause more people to be taken advantage of. AARP notes its "particular" concerns with "predatory mortgage lending" and "telemarketing fraud" perpetrated by "fly-by-night" companies. AARP *Amicus* Br. 4-5. But this concern focuses primarily, if not exclusively, on fraud by corporations. Discharge under Chapter 7 is available only for "individuals," 11 U.S.C. § 727(a)(1), and the nondischargeability provisions of § 523(a) have no application in the context of a corporate bankruptcy. The release of corporate entities from pre-existing debts is governed by provisions of chapter 11 that are not at issue in this case. *See* 11 U.S.C. § 1141(d).

The state *amici* express concern about discharge of debts that allegedly arise from sales of "securities." Ohio *Amicus* Br. 8. But, as discussed above, *see* pp. 29-30 *supra*, the recently enacted Section 523(a)(19) precludes discharge of "any settlement agreement entered into by the debtor" in a case alleging violation of securities laws or common-law fraud in connection with the purchase and sale of securities.

generous enough to buy out the fraud claim that would support nondischarge. That such opportunism is conceivable does not remotely suggest that it is now or has ever been a concern of substantial moment in the real world. It is only one of many forms of questionable behavior that lurk as temptations in any process that seeks to compromise and reconcile the legitimate interests of creditors with the debtor's procedural protections in bankruptcy and his ultimate right to a discharge and a fresh start.

In any event, as petitioners themselves note (Pet. Br. 25), this concern is already addressed by the Bankruptcy Code in two ways — through the laws of preference, *see* 11 U.S.C. § 547, and fraudulent conveyance, *see id.*§ 548. These provisions empower the bankruptcy trustee to avoid certain transfers from debtor to creditor in order to "facilitate the prime bankruptcy policy of equality of distribution among creditors." 5 *Collier on Bankruptcy* ¶ 547.01, *see* H.R. Rep. No. 95-595, at 177-78.

In order to avoid a preferential transfer, the trustee must show that (1) the transfer was for the benefit of a creditor; (2) the transfer was on account of an antecedent debt owed by the debtor before the transfer was made; (3) the transfer was made while the debtor was insolvent;[10] (4) the transfer occurred during the designated prepetition period (90 days or one year, depending on the facts); and (5) the transfer enabled a creditor to receive more than the creditor would have received if it were a Chapter 7 case, the transfer had not been made, and the creditor received a distribution under Chapter 7. *See* 11 U.S.C. § 547(b). Focusing on these five elements, a trustee need not prove either the intent of the debtor to prefer a certain creditor or the knowledge of the creditor that the debtor was insolvent, in order to exercise the preference

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[10] There is a rebuttable presumption that the debtor was insolvent if a transfer occurs during the 90 days before the bankruptcy petition was filed. *See* 11 U.S.C. § 547(f).

avoidance power. 5 *Collier on Bankruptcy* ¶ 547.01. Thus, the hypothetical situation suggested by petitioners — a debtor settles a claim for an unreasonably large amount in order to turn it into a dischargeable claim, thereby entitling the claiming creditor to a larger share in the bankruptcy estate — will on some facts amount to a proveable preferential transfer if it occurred within the preference period.

The fraudulent conveyance provisions of Section 548 offer competing creditors slightly different protections.[11] First, a trustee can avoid a transfer having the elements of common-law fraud — *i.e.*, if the debtor made the transfer or incurred the obligation with an actual intent to hinder, delay or defraud any entity to which the debtor was or became indebted. *See* 11 U.S.C. § 548(a)(1)(A). Second, a trustee can avoid a transfer without proof of the debtor's fraudulent intent if it was made while the debtor was insolvent in exchange for value that was less than equivalent to the value of the asset. *See id.* § 548(a)(1)(B).

Petitioners contend in a footnote, Pet. Br. 27 n.18, that the law of fraudulent conveyance would not provide sufficient protection against the risk of unfair treatment among creditors "because a creditor may defeat a fraudulent conveyance challenge merely by showing that he personally received 'approximately equivalent' or 'roughly equivalent' value." But if, as petitioners assume, these allegedly troubling settlements will be for amounts "roughly equivalent" to the value of the claims being settled, can this supposed abuse really justify overthrowing settlement agreements as petitioners advocate?

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[11] Under 11 U.S.C. § 544(b), a bankruptcy trustee can also use the applicable state laws of fraudulent conveyance to avoid a transfer. These state laws, generally modeled after either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, often have longer reach-back periods than the federal statute. *See* 5 *Collier on Bankruptcy* ¶¶ 548.01[2] & [3].

In addition, petitioners fail to discuss the category of fraudulent conveyance based on common-law fraud. In evaluating whether a transfer amounts to common-law fraud, courts often infer intent from the surrounding circumstances, drawing inferences and relying on any number of "badges of fraud." *See* 5 *Collier on Bankruptcy* ¶¶ 548.04[2][a] & [b]. Given the flexible character of this inquiry, pre-petition settlements with creditors paying excessive amounts to render a claim dischargeable may in some cases be subject to challenge as a deliberate defrauding of other creditors by diverting a portion of the estate assets to extinguish an otherwise nondischargeable claim.[12]

In sum, petitioners' concern about the hypothetical risk of misallocation of assets as between creditors does not remotely justify a categorical refusal to enforce otherwise binding settlement agreements in which a creditor relinquishes its right to raise issues of fraud against a debtor.

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[12] Some of petitioners' *amici* suggest that affirming the decision below would "give to the perpetrators of fraud a tantalizing incentive to settle any of their fraud-related debts just before filing bankruptcy." Ohio *Amicus* Br. 11; *see also* Brunstad *Amicus* Br. 5 (asserting that debtors may "settle their claims for illusory sums, and then file for bankruptcy to extinguish them"). But any such settlement should only put to rest a creditor's fraud claim where that creditor decides, for good and sufficient reasons, that his interests so dictate. Where the creditor has somehow been tricked into the settlement agreement, such conduct may be its own act of fraud which, when proven, may vitiate the settlement entirely or offer a basis for a claim of nondischargeability.

Petitioners failed to raise any such timely claim in this case and they assert no such contention here. *See* p. 6 *supra*; Pet. Br. 8 n.5. And, in all events, as the district court below noted, Pet. App. 25a, the facts of this case do not support any fraud-in-the-inducement claim given that $200,000 of the $300,000 settlement amount was paid immediately.

CONCLUSION

For foregoing reasons, this Court should affirm the judgment of the Court of Appeals.

Respectfully submitted,

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